

# The *Ambachtsheer* Letter

*Research and Commentary on Pension Governance, Finance and Investments*

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## HOW MUCH IS GOOD GOVERNANCE WORTH?

*“The emphasis of ABP’s new mission statement is on the achievement of a sustainable pension system which is attractive to young and old, and which remains affordable thanks to sound financial management... the Board of Governors has opted for good governance based on accepted principles...”*

ABP Annual Report, 2005

### **Governance Quality and Organization Performance Should Be Related**

Imagine two boards of pension fund governors (or trustees, or directors). Board #1 has been carefully selected based on a template that sets out optimal board composition in terms of the relevant collective skill/experience set, positive behavioral characteristics, and an unconflicted passion for the well-being of the organization and its participants. Board #2 was randomly selected out of the telephone book. Which of these two boards do you think will provide more effective oversight in the creation and maintenance of pension arrangements that are, in the words of the 2005 Annual Report of the €200B Dutch public sector pension fund ABP “sustainable, equally attractive to young and old, and affordable thanks due to sound financial management”?

If you answered “Board #1”, we are in agreement. This same answer was also given by an international group of 63 senior pension executives who responded to a survey question “What do you see as the more important governance issues facing your Board of Governors at this time?” The executives said that they deemed governance effectiveness issues to be very important, and that they saw effective board selection and evaluation processes as the heart of the matter (see last month’s *Letter* for details). Only Boards with relevant collective

skill/experience sets, appropriate behaviors, and the right motivations can provide the oversight and delegation disciplines necessary for pension fund organizations to offer its participants the sound financial management necessary for sustainability and affordability.

Most of us would probably also agree that with perfect metrics representing governance quality and organization performance, we would be able to statistically ‘prove’ that our hypothesis about the positive relationship between governance quality and pension fund performance was correct. In fact, we will state upfront here that we believe that such an exercise would show ‘high performance’ governance and management to be ‘worth’ as much as 3% of additional fund return per annum. However, these perfect metrics do not exist, and never will. Does that mean we should never try to test the ‘positive relationship’ hypothesis with less than perfect numbers? No, it does not. There is still great value in attempting the measurement journey. Even if, in the end, the final destination is not reached, much can still be learned along the way.

This *Letter* describes such a ‘search for a positive statistical relationship’ journey, including what we learned about the measured relationship between governance quality and pension fund performance along the way to the final destination.